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ERNST & YOUNG CUSTOMS AND INTERNATIONAL TRADE UPDATE

Source: WG&L Journal of International Taxation

This article covers recent developments in customs and trade including the "first sale for export" rule, the convergence of transfer pricing and customs valuation, and developments in the EU, Brazil, Canada, China, and Colombia. The authors are listed at the end of each section.

THE FUTURE OF "FIRST SALE" CUSTOMS VALUATION

Companies that import merchandise subject to multiple sales prior to importation have benefited from "first-sale" customs valuation in certain jurisdictions, such as the U.S. and European Union.¹ Suddenly the future of this popular duty savings strategy is uncertain.

First-sale customs valuation allows importers to declare the price paid in the earlier sale (i.e., first sale) for customs purposes, resulting in a lower dutiable value and thus lower customs duty liability. For example, there are many situations in which a contract manufacturer sells a product to a procurement company, which resells the product to a U.S. distributor, but the product is shipped directly from the manufacturer to the U.S. Under the first-sale rule, the manufacturer-to-procurement company sale is used for customs valuation.

Last summer, the World Customs Organization (WCO) Technical Committee on Customs Valuation surprised many with the release of Commentary 22.1, *Meaning of the Expression "Sold for Export to the Country of Importation" in a Series of Sales*, which expressed a preference for the use of the "last sale" when there are a series of transactions that cause the importation of merchandise. A WCO Technical Committee Commentary is only advisory, and would not by itself change current practice in jurisdictions with clear authority supporting first-sale customs valuation, such as the U.S. or EU. However, recent developments in the U.S. have many wondering if first-sale customs valuation has a future.

U.S. CUSTOMS PROPOSAL TO ELIMINATE FIRST-SALE VALUATION.

In January 2008, the U.S. Bureau of Customs and Border Protection (CBP) issued a Notice² proposing a new interpretation that would



effectively eliminate “first-sale” valuation. Citing the WCO Commentary, CBP proposes to base transaction value on the last sale prior to the introduction of the product into the U.S. Using the “contract manufacturer to procurement company to U.S. distributor” example, the second sale from the procurement company to the U.S. distributor would be used under CBP’s proposed new interpretation. The result is a higher dutiable value for the transaction and thus higher customs duty liability.

In the U.S., the first-sale rule was established in a series of court cases. The seminal case was *Nissho Iwai America Corp.*, 982 F.2d 505 (CA-F.C., 1992) CBP subsequently issued its own guidance on meeting first-sale requirements, including TD 96-87,³ an Informed Compliance Publication titled *Bona Fide Sales & Sales for Exportation to the United States*, and several published Customs rulings. Based on its new assessment that *Nissho Iwai* was wrongly decided, the Notice states that if the newly proposed interpretation is finally adopted, it will result in the revocation of TD 96-87, modification or revocation of all previously issued first-sale rulings, and revocation of any first-sale treatment previously given by Customs. Application of any prior court decisions would be limited to the facts of the case.

The new treatment would have only prospective application from the date of final adoption. The Federal Register Notice solicits public comments on the newly proposed interpretation through April 23, 2008. If adopted, the new position would have substantial impact. Relying on the availability of first-sale valuation, many companies have established supply-chain structures that use a “buy-sell procurement company,” a foreign company that purchases products from foreign factories and resells to distribution companies in local markets. These structures have historically been considered “customs neutral” in the U.S.; insertion of the buy-sell procurement company into the supply chain could allow supply chain efficiency and income tax benefits without changing the customs duty cost from that which previously occurred when the U.S. distributor purchased product directly from the factory. If the first-sale rule is eliminated, businesses using this structure will face increased, unanticipated, customs duty costs.

The demise of the first-sale rule is not certain, however. First, CBP requested public comments, many of which will be critical of CBP’s decision to change its interpretation 15 years after *Nissho Iwai*. If, after consideration of public comments, CBP chooses to issue a final notice announcing the change in policy, it will likely invite litigation. In addition, some members of Congress have expressed an interest in reviewing the situation, which could lead to legislative action that would supersede CBP’s interpretation.

Even with final resolution uncertain, many companies are engaging in contingency planning. There are often alternative structures that importers may consider where firstsale qualifications are not met; these structures would remain viable even if the newly proposed interpretation is adopted in the U.S.

EU EXPECTED TO MAINTAIN FIRST-SALE POSITION.

Will these recent developments in the U.S. have a direct impact on the EU position for the first-sale valuation method? So far, there is no indication that the EU position will change. The EU Commission has not yet reacted to WCO Commentary 22.1 or the Notice, and from our contacts with the EU Commission, it appears that no actions are expected on short notice.

Unlike in the U.S., the first-sale rule is actually implemented in the EU customs legislation. Article 147 (1) of the Community Customs Code Implementing Regulation provides in the third paragraph:

- Where a price is declared which relates to a sale taking place before the last sale on the basis of which the goods were introduced into the customs territory of the Community, it must be demonstrated to the satisfaction of the customs authorities that this sale of goods took place for export to the customs territory in question...

The Customs Valuation Section of the EU Customs Code Committee has issued further guidelines in applying Article 147 of the Community Customs Code Implementing Regulation. The Committee gives detailed information and examples of the criteria relevant for the supporting evidence to be produced by the importers.

Thus, the first-sale concept is clearly recognized in the EU customs legislation and explanatory guidelines from the European Commission. To remove the first-sale valuation method, first the EU regulations would have to be modified—a lengthy process given that all 27 EU member states must agree on the changes of the implementation regulation.

On the other hand, the European Commission recently adopted the Modernized Customs Code (MCC). It is also anticipated that the Commission and the member states will develop a new Implementing Regulation to the MCC that will contain detailed rules regarding customs valuation. Development of this new Implementing Regulation gives the Commission and the member states the opportunity to rethink the concept of firstsale valuation. Adoption of this new Implementing Regulation is expected to take place at the end of this year or the beginning of 2009. We recommend that companies currently involved in first-sale structures into the EU closely follow these developments. In addition, companies that are reexamining alternatives to first-sale in the U.S. may want to simultaneously consider the impact in the EU.

SCRUTINY OF ALLOWABLE FIRST SALES.

U.S. importers may continue using first-sale valuation prior to the adoption of a final interpretation, and, of course, there is no change currently pending in the EU. Nevertheless, with the attention given to the topic, we think it prudent for any business using or contemplating a first-sale structure into the U.S. or the EU to carefully review first-sale supporting documentation. Regardless of the outcome of the CBP proposal, we expect CBP and the EU customs authorities to increase scrutiny of first-sale documentation.

- Bill Methenitis, Dallas; Kristine Price, New York; Walter de Wit and Jeroen Scholten, Amsterdam

CONVERGENCE OF TRANSFER PRICING AND CUSTOMS VALUATION

The convergence of transfer pricing and customs valuation is showing signs of progress.⁴ The 2006 and 2007 Joint WCO and Organization for Economic Cooperation and Development (OECD) conferences

on transfer pricing and customs valuation successfully brought together government representatives and the business community to discuss the differences, understand the issues, and examine the desirability and feasibility of convergence. Ever since, there has been growing attention on convergence opportunities.

TRENDS.

In many countries, there is more cooperation between customs and tax authorities through information sharing, simultaneous dialogue, and cross-training. For instance, Canada's tax and customs administrations each issued the same guidance on income tax transfer pricing and customs valuation. Some countries, including the U.K., have gone so far as to merge customs and tax administrations into a single revenue collection department.

There is an emerging movement towards joint customs and transfer pricing enforcement. For example, Spain has formally moved to conducting joint customs and tax audits of taxpayers with assets greater than 100 million euros. This increase in joint customs and income tax administration is a trend that we expect to continue in 2008.

CONVERGENCE BETWEEN CORPORATE TAX AND CUSTOMS FUNCTIONS.

The convergence trends between tax and customs administrations, however, have not necessarily translated into more collaboration between the corporate transfer pricing and customs functions. *Ernst & Young's 2007-2008 Global Transfer Pricing Survey (Survey)*, released in December 2007, reported that fewer than half of parent-company respondents said that the person responsible for transfer pricing in their organization has either input or control over setting prices for indirect tax purposes. This surprisingly minimal overlap in customs and transfer pricing oversight is not limited to establishing prices. For instance, fewer than half of parent-company respondents coordinate posttransaction adjustments between the transfer pricing and customs systems.

These findings are cause for concern, especially considering that the Survey confirms active coordination between customs and tax administrations.

Thirty-three percent of parent company respondents that have undergone a transfer pricing or customs audit reported being aware of information exchange between the two agencies.

Yet, perhaps the Survey findings portray a reality that, despite the increasing joint efforts, companies face a general lack of clarity and consensus from authorities regarding the alignment of customs and transfer pricing values and documentation requirements. For instance, Canada accepts transfer pricing data to support customs valuation, whereas CBP has cautioned importers against relying solely on transfer pricing documentation or an advance pricing agreement (APA) to support customs values—a move that has caused quite a bit of consternation across the trade community.

WHAT'S AHEAD?

The need for more clarity, consensus, and business certainty are significant issues. Concrete solutions would aid both business and customs and tax authorities. Perhaps an important step was the WCO's formation of an international Focus Group on Transfer Pricing and Customs Valuation following the second joint WCO/OECD Conference. The Focus Group, comprised of representatives from the WCO, OECD, World Trade Organization (WTO), customs administrations, tax authorities, and private sector met in October 2007 to discuss the issues and propose solutions.

We also anticipate additional local guidance in many jurisdictions to provide more certainty for businesses. For instance, Australia has announced an APA program that would jointly address transfer pricing and customs valuation issues. Korea has similarly announced an APA mechanism for customs value. In the U.S., CBP officials have stated their intention to soon request comments with respect to the use of transfer pricing concepts in customs valuation.

There has been significant progress over the last year with increased awareness of the need for convergence opportunities that provide clarity, consensus, and business certainty in establishing acceptable intercompany prices for cross-border transactions under both tax and customs guidelines. Yet, more concrete guidance

is necessary for there to be real progress. Until that time, however, companies should not stay idle, especially considering the convergence momentum. There are strategies for companies to better manage the interplay of transfer pricing and customs in the current environment, and we expect more progress within organizations with more collaboration between the two functions. Overall, it should be another eventful year for the convergence of transfer pricing and customs valuation.

- Bill Methenitis, Dallas

U.S. GETS CLOSER TO IMPLEMENTING "10+2" ADVANCE DATA SECURITY FILING REQUIREMENTS FOR IMPORTS

CBP began the new year by issuing the highly anticipated Notice of Proposed Rulemaking (NPRM),⁵ which outlines the proposed Importer Security Filing and additional carrier requirements. The proposed rule would require that importers, or their agents, and carriers transmit additional data elements (see sidebar for list) for non-bulk cargo prior to being brought into the U.S. by vessel. These data elements, known as "10+2" (ten for importers, two for carriers) are in addition to what is already currently being submitted under the 24-hour rule, which requires certain manifest information 24 hours prior to lading for containerized and non-exempt bulk cargo.

Under the proposed regulations, the importer would be required to transmit the Importer Security Filing electronically via Automated Broker Interface (ABI) or the Vessel Automated Manifest System (AMS). The information will feed into CBP's Automated Targeting System (ATS) to identify high-risk shipments for inspection. The feed of the 10+2 data elements aims to fulfill the requirements of section 203 of the Security and Accountability for Every Port Act of 2006 (SAFE Port Act) to further improve the ability of CBP to identify high-risk shipments in order to prevent smuggling and ensure cargo safety and security.

As proposed, importers will be responsible for transmitting the ten additional data elements for goods intended to be entered

into the U.S. or delivered to a foreign-trade zone (FTZ) no later than 24 hours before cargo is laden on a vessel destined to the U.S., with the exception of foreign cargo remaining on board (FROB). The requirement for FROB would be anytime prior to lading. For carriers, the two additional elements, vessel stow plan and container status messages (CSMs), must be transmitted no later than 48 hours after departure from the last foreign port and daily, respectively. The NPRM indicates that violations would result in liquidated damages.

The additional data elements provide CBP with a better look at the international supply chain, but many companies consider some of these data elements proprietary business information and have expressed concerns, including confidentiality and the prospect that the information could be used for purposes other than safety and security. CBP has acknowledged these concerns and the NPRM states that the data elements should be kept confidential, except to the extent required by law, and "used exclusively for ensuring cargo safety and security and preventing smuggling" rather than for other commercial enforcement purposes.

Also, companies along the supply chain are concerned about the cost of change, both from a financial cost and supply chain delay perspective. With the expanding security filing data requirements, the company and supply chain partners will need to make changes to their systems and processes to ensure that the required data can be reported accurately and timely. In an independent Cost, Benefit, and Feasibility Study⁶ prepared for CBP, as required under the SAFE Port Act, the annualized undiscounted cost to importers is estimated at \$300 to \$520 million in year 1 (2008). Cost per shipment is estimated at \$20-\$38. Further, according to the study, the requirement may increase the shipment transit time, especially for consolidated shipments, and cause a supply chain delay estimated at 24 hours for the first year and 12 hours for subsequent years.

Senior CBP officials counter that this additional shipment detail is absolutely necessary to further improve its targeting precision. Without such an improvement in statistical targeting accuracy, CBP will be hard-pressed to answer Congress' call for

significantly increased cargo inspections. CBP feels that such mandated increased cargo inspections would cost the trade in multiples of the cost of implementing 10+2 in terms of supply chain disruptions and administrative effort. In addition CBP notes that 10+2 information will clearly identify CTPAT participants' shipments and ensure that they receive release priority.

Clearly, the 10+2 requirements are a significant change for supply chain operations. Companies should keep in mind that advance customs data is expected to become normal business practice for international trade shipments, supported by the WCO SAFE Framework of Standards to Secure and Facilitate Global Trade. A growing number of countries have implemented advance customs data requirements, including the EU, Canada, Australia, and New Zealand. The international supply chain is becoming more transparent with more importance placed on data management.

Overall, the 10+2 NPRM is not breaking news. Rather, CBP has been openly developing the additional requirements with various trade organizations, and the additional data elements in the NPRM have been known for some time. However, the issuance of the NPRM does signal that the 10+2 change is inevitable and companies can no longer delay adapting to the new rules. CBP has not indicated when the final rule will go into effect, but did indicate that similar to the 24-hour rule, there will be a phase-in process for 10+2.

- Ray Shaw, Dallas; Liana Thomas, San Francisco

EU EASES ELIGIBILITY FOR GSP BUT SHIFTS RISK TO TRADE

A proposed EU Regulation, expected to come into effect on January 1, 2009, eases the eligibility requirements for preferential tariff treatment under the Generalized System of Preferences (GSP) for products made in developing countries. At the same time, responsibility for determining and supporting product eligibility would be shifted to the trade. This signals significant opportunities for exporters in GSP countries and EU importers, but not without risk.

The current EU GSP origin rules are both onerous and complex, particularly because the requirements vary from product to product, and may require a change of tariff heading, a value-added test, specific-process test, or frequently a combination of these. Also, the criterion under the value-added test can be prohibitive. For example, a value-added test normally applies to technology products, and the current rules require 60%-70% local value content, which is extremely difficult to achieve in many developing countries.

The proposed new rules serve to reduce the local-content requirement. The general rule will be a simple value-added test requiring only 30% local-value content—this includes profit, processing costs, and local materials. Further, some foreign materials or components can be counted as local content, such as materials from the EU or, subject to certain conditions, from other countries including Norway, Switzerland, or recognized regional groupings (e.g., ASEAN), but there must still be more than minimal processing in the GSP country.

For a limited number of products, qualification requires a higher local content, or is subject to additional requirements. These exceptions are for listed agricultural products and non-agricultural products that are deemed "sensitive," including certain chemicals, textiles and clothing products, and key consumer audio and video appliances. For countries on a list of "least developed countries," the additional requirements for nonagricultural products do not apply (i.e., the general 30% threshold can be used).

The second area of significant change concerns the administrative arrangements for qualification, proof of origin, and claiming GSP preference. A key issue, discussed below, is that the Regulation will shift the compliance and duty risks to exporters and importers. While these changes will come into effect only in 2012, they represent a significant challenge for all companies, exporters and importers alike, which will have to introduce new compliance and risk procedures.

Under the new arrangements, manufacturers must become registered GSP exporters. Proof of GSP origin (which will no longer need to be shipment by shipment) will be provided directly by the exporter and without any review or authentication by the local customs or

other authorities.

The new arrangements are intended to simplify the administrative requirements, but also—and this represents a fundamental change—they shift the compliance and risk away from the authorities and onto the exporter and its customer in the EU. If GSP entitlement is found to have been incorrectly claimed, the GSP exporter stands to lose its GSP registration (precluding future use of GSP) and the EU importer can be held responsible for any underpaid duty. A further risk for companies is that GSP preference can be withdrawn for a country if the authorities there do not comply with conditions set by the EU Commission for establishing effective procedures and controls.

At the same time that these new rules come into effect, the EU GSP preferences will be redefined for 2009-2012. While major changes are not anticipated, there may be some modifications to eligible countries and product scope, which companies should also factor into their sourcing and trade plans.

Companies, including contract manufacturers, should examine the proposed rules and upcoming GSP preference changes carefully as they may provide new opportunities to eliminate duty on product destined for the EU market or establish new business or production operations in GSP countries. The issues of risk and compliance will be more important in the future and with consequences that will directly affect the use of GSP and the claiming of preferences. Companies will therefore need to protect their duty exposure and long-term use of GSP by implementing effective controls and processes for compliance.

- Colm Halpin, Dublin

BRAZILIAN TRADE/CUSTOMS DEVELOPMENTS

These include new financial transaction taxes and a new regime for express courier importations.

NEW RULES FOR FINANCIAL TRANSACTION TAXES.

The Brazilian government issued a series of economic measures at the beginning of

2008 that affect Brazilian traders. These latest measures are in response to the elimination of the Provisory Contribution on Financial Transactions (CPMF), a tax levied on bank transactions that had previously been a significant source of government revenue. The CPMF was created by a constitutional amendment in 1996 to finance expenses resulting from the health sector and projected to last only two years. After several renewals, in December 2007, the Brazilian Congress voted against the proposal for its extension until 2011. As a result, CPMF was eliminated as of January 1, 2008.

Since the demise of CPMF, there has been a frenzy of new tax laws, thought to be an attempt to offset the resulting loss of government revenue. Discussed below are the new rules on the tax on financial transactions (*imposto sobre operacoes financeiras* or IOF) and a surprising new import tariff under Provisional Measure 413 (discussed below). While these new laws are causing concern among Brazilian traders, their survival is already in doubt as legal challenges are underway.

Decree 6,339 (January 3, 2008) increases the existing IOF tax rates from 0.0041% to 0.0082% for financial transactions, such as granting credit, discount operations, and financing the acquisition of nonresidential real estate. An additional IOF tax of 0.38% applies to certain transactions, including foreign exchange transactions related to the export of product and services and the import of services.

Perhaps not coincidentally, the 0.38% rate of the new IOF tax equals the tax rate previously assessed under the CPMF, demonstrating the obvious substitution of one tax for another as a way to compensate the CPMF revenue lost. However, the tax-triggering events are different. CPMF was triggered when legal entities or natural persons had financial transactions (i.e., any liquid operation or charge performed by financial institutions resulting in currency circulation). On the other hand, IOF's tax triggering events are, in general, credit, foreign exchange, and insurance operations.

The new IOF tax of 0.38% represents an additional cost to many Brazilian traders. The Decree creating the tax, however,

raises several constitutional questions that have been challenged before the Brazilian Supreme Court by Brazil's Democrats Party. Depending on the Court's ruling, additional changes to the IOF tax may follow.

UNEXPECTED IMPORT DUTY RATE INCREASE.

On January 4, 2008, the Brazilian government issued Provisional Measure 413, which in addition to various tax measures, established rules to increase the import duty rates for 11 different tariff categories of products. The new rules apply an *ad rem rate* (i.e., fixed amount per quantity of product) of R\$10.00 (approximately U.S.\$5.80) per kilogram or other unit of measure (e.g., units, cubic meters). The *ad rem* rates will replace the *ad valorem* rates so that the calculation of the import duties will not consider the customs value, but rather the quantity. The affected industries include beverages, plastics, rubber, textiles, apparel, footwear, medical and hospital products, tools, watches and clocks, optical products, and furniture.

There have already been legal challenges to these provisions, claiming that the rules violate Brazil's agreement with its Mercosur partners, which requires that any duty in excess of 35% should receive prior approval from the other members (Argentina, Paraguay, and Uruguay). There have been reports that the Brazilian federal government is studying alternatives to the new import tariff, which would better serve to protect the national industry, especially the sectors of textiles, apparel, and footwear that face strong competition from China, while not impairing Brazil's foreign commercial partners. Further developments are expected soon.

BRAZIL'S MODERNIZED REGIME FOR EXPRESS COURIER IMPORTS.

Another example of the modernization of Brazil's customs processes is the transition from paper to electronic filings for import declarations through express couriers. This change further opens Brazil's consumer market to foreign companies looking to expand their international sales in Brazil with door-to-door sales.

Brazilian legislation provides the possibility

of performing import transactions through courier companies under certain restrictions. Basically, a courier can clear goods that are for individual use (i.e., not for resale) or have no commercial value (e.g., samples or products) and are valued at less than U.S.\$3,000 (or equivalent amount in other currency). Otherwise, the importation must be cleared through a customs broker.

The customs clearance is performed by the express courier, which files the Declaration of Express Package for import (*Declaração de Remessa Expressa de Importação* or DRE-I). In the past, such filings were done manually with paper transactions, which increased the cost and delivery times. The introduction of electronic filings for the DRE-I represents a more efficient means to conduct door-to-door international sales.

Goods imported under these conditions are subject to a different method of import taxation. Specifically, instead of triggering import duty, IPI (Federal VAT), and PIS/COFINS (social contributions),² such imported goods are subject to a single import duty rate of 60% regardless of the customs tariff classification. Such taxation and the previously described procedures are part of the Simplified Import Regime. For some products, this type of importation can be more cost-effective. However, ICMS (state VAT) also applies unless the purchase is less than U.S. \$50.

With electronic filings, the Simplified Import Regime becomes a feasible alternative means for foreign goods to reach the Brazilian market using an express courier service. The special tax treatment may be advantageous, assuming that both the express courier and the Brazilian customers comply with all legal requirements.

- Frank de Meijer and Ana Luisa Poiani, Sao Paulo

CANADIAN TEXTILES AND APPAREL—PROPOSED NEW DUTY SAVINGS STRATEGY

On December 1, 2007, the Department of Finance published a Canada Gazette notice stating the government's intention to implement an outward processing initiative for textile and apparel products.

The initiative supports the Canadian government's October 2005 commitment to design and implement measures to help the Canadian textile and apparel industry find new market opportunities, while also supporting the government's economic development objectives regarding developing countries.

Basically, the outward processing proposal promotes the incorporation of Canadian textiles in apparel produced in General Preferential Tariff (GPT) countries for the Canadian market by granting a conditional remission on all or a portion of the customs duty assessed on the apparel imported into Canada. To be eligible, the apparel must be made in whole or in part from textiles produced in Canada. Further, the apparel must be produced in, and shipped directly from, the same GPT beneficiary country to which the textiles produced in Canada were exported. The remission of customs duties would be equal to the lesser of (1) the value of the textiles produced in Canada and incorporated into the imported apparel, or (2) the customs duty assessed on the imported apparel.

Canada's GPT program currently applies to 177 countries and customs territories (per the List of Countries and Applicable Tariff Treatments set out in the schedule to the *Customs Tariff*). The program grants preferential tariff rates for products produced in these developing countries, except for certain "sensitive" products, including most textiles and apparel. Thus, the proposed outward processing initiative is a significant new opportunity for textile and apparel manufacturers looking to establish production in low-cost markets.

- Werner Kreissl and Sylvain Golsse, Montreal

CHINA TRADE/CUSTOMS DEVELOPMENTS

These include a WTO ruling against China in an auto parts importation dispute and a flurry of customs-related regulatory changes.

WTO RULES AGAINST CHINA IN AUTO PARTS DISPUTE.

The WTO Dispute Settlement Body has ruled against China's measures affecting the

importation of auto parts, siding with the complainants, the U.S., the EU, and Canada. This is China's first encounter with the Dispute Settlement Body since it joined the WTO in 2001 and represents a strong blow against China's aggressive trade policies.

As background, China implemented aggressive new reforms in April 2005 with Decree No. 125, *Measures for Administration of Importation of Automotive Components that Constitute Complete Vehicle Character*, with the effect of capturing many imported auto parts and components at the higher "complete vehicle" duty rate, if the imported parts were incorporated in a vehicle that did not meet local content requirement thresholds. In many cases, the result was the doubling of the duty expenses.

In March 2006, the EU and the U.S., later joined by Canada, filed complaints with the WTO essentially arguing that China's rules discouraged auto manufacturers in China from using imported parts. In March 2008, there were reports that the Dispute Settlement Body Panel issued its interim ruling against China in almost all points of contention. The final ruling is expected to be officially released shortly. From that point, China would be able to appeal and given an opportunity to make legislative changes before the WTO would authorize any retaliatory sanctions.

It is difficult to predict how China will react once the WTO Panel releases its final ruling. In addition to the damaging effects on foreign auto parts suppliers, Decree No. 125 and related measures have placed strenuous requirements on Chinese automotive manufacturers.

CUSTOMS-RELATED REGULATORY CHANGES.

2007 resulted in an unprecedented number of amendments to the rules and regulations affecting goods imported to and exported from China. Many of the rules were issued to address the fundamental economic issues of managing the trade surplus and guiding the growth of certain industries. In December 2007, the China authorities continued with this trend of regulatory revisions, already taking effect in January 2008. Highlighted below are some of these recent changes that could have a material impact on business.

IMPLEMENTATION OF 2008 CUSTOMS TARIFF.

In December of every year, the State Council issues an updated Customs Tariff with changes to import and export duty rates for the upcoming year. On December 14, 2007, Notice 25 [2007] introduced significant changes in the following three areas:

- *Most favored nation (MFN) import duty rates.* The duty rates on 45 different harmonized system (HS) codes were permanently reduced in line with China's WTO commitments. A majority of these changes (35 of 45) related to the HS chapter 39, which covers plastics and articles thereof. The affected chapter 39 product duty rates were decreased from an average 7.6% to 6.5%. Other changes were less dramatic and in the range of import duty rate reductions of 3%-5%.
- *Interim import duty rates.* China maintains a list of products where a temporary reduction in the MFN rate, once decided, applies to products imported after January 1. These interim duty rates are subject to change throughout the year; some are revised and others continue for the full year. The interim import duty list for 2008 covers 620 HS codes with over 300 new additions for 2008. By including so many more products with lower interim rates, China appears to be providing favorable duty treatment for several foreign products and is further opening the marketplace. Big winners include HS chapters 28, 84, 85, 90, 94, and 95 ^B with significant newly added categories. Also, numerous items, including many household appliances, have been afforded significant benefits from a reduced duty rate.
- *Interim export duty rates.* Included in the tariff update, Customs released a list of products subject to stiff export duty rates. China has applied export duties on targeted products for several reasons, such as restricting export volumes to help balance the trade surplus and discourage the exportation of products that China deemed vital to domestic development. Thus, products like steel, cement, magnesium, and basic metals, among others, are

assessed with export duties. There are now 334 HS codes attracting interim export duty rates ranging between 0%-30%.

SECOND BATCH OF PROHIBITED PROCESSING TRADE PRODUCTS.

Processing Trade is a program for export manufacturers that allows them to import raw materials "bonded" or without the payment of duty and VAT as long as they are incorporated into exported finished

goods. China, in 2007, was tinkering with the types of products in the prohibited and restricted lists to encourage or discourage the development of certain industries and products that (1) caused environmental pollution; (2) consumed large amounts of energy in the production process; (3) used China's natural resources; or (4) were considered low-value added. This reduced the number of manufacturers receiving the benefits of Processing Trade.



KEEP TRANSFER PRICING PENALTIES AT ARM'S LENGTH!

Important Guidance from WG&L!

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About the Authors:

• Cym H. Lowell, partner in the Dallas office of Gardere Wynne Sewell, LLP.

• Peter L. Briger, founder and senior partner of Briger & Associates, New York, New York.

• Mark R. Martin, partner in the Houston office of Gardere Wynne Sewell LLP.

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TAX & ACCOUNTING



On December 21, 2007, another batch of 589 HS codes was added to the prohibited list. The regulations became effective on January 21, 2008, and provided for the grandfathering of certain companies with processing contracts already in place before the effective date. The rules apply to all bonded zones, but do not affect companies already established in bonded zones prior to the issuance of this Notice. The main groups of product introduced to the Prohibited List during this last round included:

- Any product (e.g., animal meat, fur, vegetable, purse, handbag, beauty products, clothing) that contains or uses parts of plants, fish, or animals considered to be in imminent danger.
- Mineral products (chapters 25 and 27) such as salt, cement, mineral fuels/oils, petroleum oils.
- Inorganic chemical, organic/inorganic compounds of precious metals (chapter 28). This chapter was the hardest hit, with almost 200 new HS codes being prohibited.
- Tanning or dye extracts, dyes, pigments, coloring (chapter 32)—a large portion of this chapter was also affected.
- Iron and steel (chapter 72)—82 new HS codes from this chapter were included in 2008.

As the summary above shows, the affected products selected for the prohibited list appear to follow the four targeting criteria used previously. If a company can no longer use Processing Trade for export production, duty and VAT will be charged on the imported raw materials. Unfortunately, there is no duty drawback program, so once customs duty has been paid by an importer, it becomes a sunk cost. In addition, many of the prohibited products have a very low or even zero percent export VAT refund rate. Thus, a significant VAT cost may be incurred on exportation of these goods.

Companies producing goods for export that are now on the prohibited list must reconsider whether their processing activities make financial and commercial sense going forward. Alternatives may be considered to reduce the impact, but the addition to the prohibited list is a big disadvantage for a manufacturer in China producing goods for export.

EXPORT VAT REFUND RATES REDUCED AGAIN.

The Ministry of Finance abolished VAT refunds on 84 agricultural products to further discourage exportation of key food and grain related items. Products, mostly in chapter 10-12, such as wheat, grains, rice, corn, oats, barley, and soybeans will no longer receive a VAT refund if exported out of China.

WHAT'S AHEAD?

The recent regulatory changes are having a material impact on Chinese exporters, overseas buyers who purchase goods made in China, and those importing and distributing in China. If the new regulatory activity at the end of 2007 is any indication of what to expect, 2008 could be another unsettling year for export manufacturers.

- Robert Smith, Shanghai

COLOMBIA—REGULATION MODIFIES FTZ REGIME

The Colombian government has been working to jump-start the free trade zone (FTZ) regime with a wave of legislative activity over the last few years. Consistent with the program's overall goal to stimulate foreign investment and create new employment, Decree 4051 (October 23, 2007) modifies the regime to allow existing companies that are already performing industrial activities of goods or services in Colombia to obtain FTZ benefits for significant new investment projects.

As background, an FTZ is an extraterritorial fiction, meaning that a designated area is considered outside the Colombian Customs Territory (CCT) so that foreign-sourced merchandise shipped into the zone is not subject to customs duties and import VAT as long as it remains in the zone or is shipped to another country. Colombia's FTZ regime also offers tax and fiscal savings, such as a special income tax rate of 15% (the normal tax rate is 33%) for industrial users, and an exemption from VAT for goods sold from the CCT to industrial users in the FTZ. To obtain FTZ benefits, companies must meet new investment and employment creation criteria.

In early 2007, Decree 383 introduced special free trade zones (SFTZs) to allow new companies that are physically located outside of the geographic FTZ area to receive full FTZ benefits. Existing companies with new projects had the option to relocate activities into an FTZ to obtain the fiscal savings.

After further review, the Colombian government issued Decree 4051 to modify Decree 383. Among other changes, this latest decree allows an existing company with new investment projects meeting specified criteria to now benefit as an SFTZ without the need to relocate. In turn, the relocation option of Decree 383 has been retracted.

In general, the following possibilities exist with varying criteria, some of which are highlighted below:

- (1) *FTZ declaration for new companies*—the company meets new investment and employment creation criteria based on asset levels.
- (2) *SFTZ declaration for new companies*—the company meets minimum new investment levels of approximately U.S.\$32 million and the creation of at least 150 new job positions within a three-year period.
- (3) *SFTZ declaration for existing companies*—the company holds total net equity of more than U.S.\$32 million at inception and agrees to duplicate its net taxable income from the previous year. Further, the company must meet minimum new investment levels of approximately U.S.\$150 million within a five-year period.

Decree 4051 also expands the FTZ regime to cover certain services with or without cargo, including health services and port societies. Agro-industrial projects gain an exemption from the requirement to create new employment positions, while the term to comply with the investment requirement is three years. On the other hand, certain industries/activities are excluded from participating in the FTZ regime, including activities that exploit natural resources (e.g., hydrocarbons industry), financial services, public services, and activities performed under the government franchise scheme.

While the above discussion highlights some of the criteria involved, interested companies

and investors must understand the full set of criteria, operational requirements, and risks involved. At the same time, companies that successfully comply with the FTZ regime gain significant fiscal advantages by investing in Colombia.

- **Gustavo Lorenzo, Juan Barbosa, and Angelica Pena, Bogata**

"10+2" ELEMENTS

Proposed Importer Required Elements

1. Manufacturer (or supplier) name and address.
2. Seller (or owner) name and address.
3. Buyer (or owner) name and address.
4. Ship-to name and address.
5. Container stuffing location.
6. Consolidator (stuffer) name and address.
7. Importer of record number/foreign trade zone applicant identification number.
8. Consignee numbers.
9. Country of origin.
10. Commodity HTS number (six-digit minimum).

Proposed Vessel/Carrier Required Elements

11. Vessel stow plan.
12. Container status message data.

FOOTNOTES

¹ - For prior coverage on the rule, see Neville, Jr., "The 'First-Sale-for-Export' Customs Valuation Rule—The Second Time Around," 16 JOIT 22 (August 2005); "First-Sale-for-Export' Rule Represents a Major Victory for Importers," 7 JOIT 72 (February 1996).

² - 73 Fed. Reg. 4254 (January 24, 2008).

³ - 52 Cust. Bull. 1

⁴ - Neville, Jr., and Harris, "The Customs/IRS Intersection on Transfer Pricing," 12 JOIT 28 (September 2001).

⁵ - 73 Fed. Reg. 90 (January 2, 2008).

⁶ - Industrial Economics, Inc., Security Filing, 10+2 Regulatory Assessment and Initial Regulatory Flexibility Analysis for the Notice of Proposed Rulemaking (December 3, 2007).

⁷ - Program for Social Integration (PIS/Contribution for the Financing of Social Security (COFINS).

⁸ - Ch. 28: inorganic chemicals; organic or inorganic compounds of precious metals, of rare-earth metals, of radioactive elements or of isotopes; ch. 84: nuclear reactors, boilers, machinery and mechanical appliance; parts thereof; ch. 85: electrical machinery and equipment and parts thereof; sound recorders and reproducers, television image and sound; ch. 90: optical, photographic, cinematographic, measuring, checking, precision, medical or surgical instruments and apparatus; parts and accessories thereof; ch. 94: furniture; bedding, mattresses, mattress supports, cushions and similar stuffed furnishings; lamps and lighting fittings, not elsewhere specified or included; illuminated signs, illuminate name-plates and the like; prefabricated building; ch. 95: toys, games and sports requisites; parts and accessories thereof.

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One New York Plaza, 34th Floor
New York, New York 10004
212-404-8600

Monmouth House
58-64 City Road
London EC1Y 2AL, United Kingdom
+44 20.7.369.7000

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